

REPORT OF EXAMINATION
OF THE
TOPA INSURANCE COMPANY

AS OF
DECEMBER 31, 2006

Participating State
and Zone:

California

Filed March 25, 2008

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Los Angeles, California
January 11, 2008

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Kent Michie
Secretary, Zone IV-Western
Commissioner of Insurance
Department of Insurance, State of Utah
Salt Lake City, Utah

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

TOPA INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 1800 Avenue of the Stars, Los Angeles, California 90067.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2006. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; accounts and records; and sales and advertising.

COMPANY HISTORY

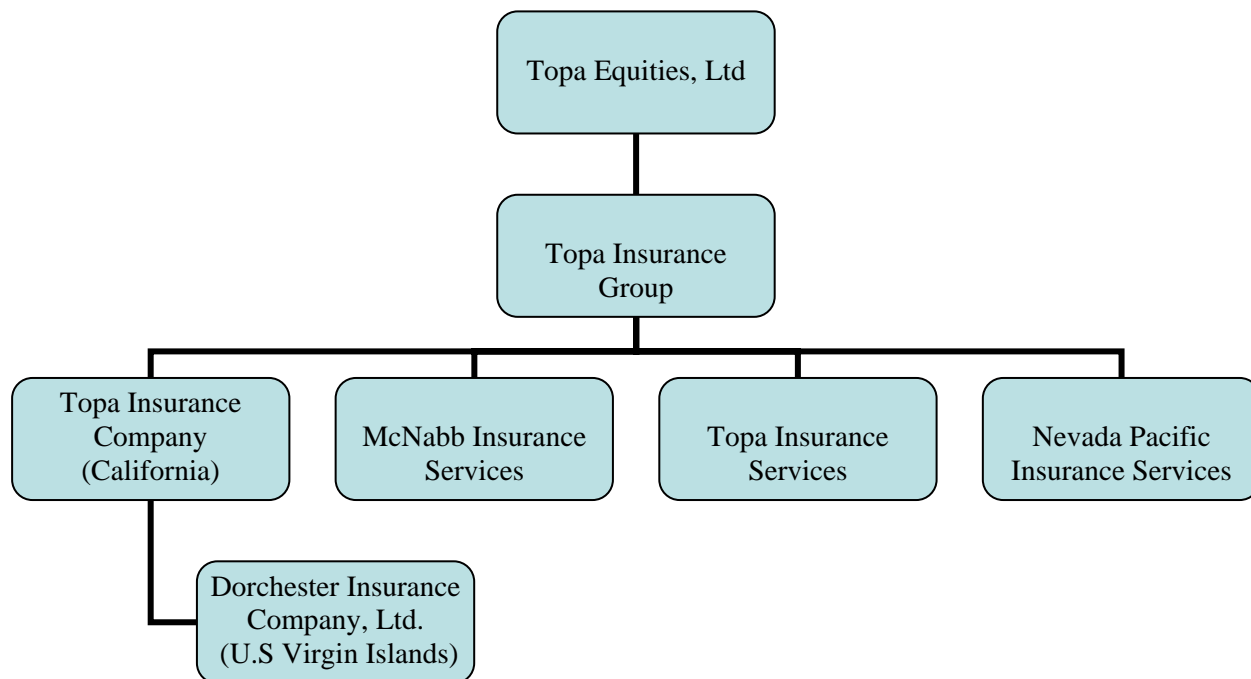
The Company was incorporated under the laws of the State of California on October 4, 1984 and began business on January 1, 1985. Prior to the receipt of its certificate of authority, the Company issued 52,000 shares of stock to Topa Capital Corporation (TCC). Upon the 1990 dissolution of TCC, all of the stock of the Company was transferred from TCC to Topa Equities, Ltd. (TEL), who wholly-owned TCC prior to its dissolution.

The Company has 200,000 authorized shares of common stock, 80,000 shares of which were outstanding. On September 6, 2006 the Company amended its Articles of Incorporation to restate its par value from \$32.50 to \$62.50 per share. This change increased common stock by \$2,400,000 and decreased gross paid-in and contributed surplus in the same amount. California Insurance Code Section 827.3(b) (3) requires notice of said transaction to be filed with California Department of Insurance (CDI) within 30 days after the transaction. The Company filed a notice with the CDI after the required 30 days on April 9, 2007. It is recommended that the Company submit future notices to the CDI in a timely manner.

During the period covered by this examination, the Company paid dividends to its stockholder totaling \$3,480,000.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which Mr. John E. Anderson is the ultimate controlling person. The following is an abbreviated organizational chart depicting the relationship of the Company within the holding company system:



(*) all ownership is 100%

Management of the Company is vested in a five-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2006 follows:

Directors

Name and Residence

Principal Business Affiliation

John E. Anderson
Los Angeles, California

President and Chairman of the Board
Topa Equities, Ltd.

William S. Anderson
Pacific Palisades, California

Executive Vice President and General Counsel
Topa Equities, Ltd.

Harry W. Degner *
Arcadia, California

Director
Topa Insurance Company

Noshirwan Marfatia
St. Thomas, U.S. Virgin Islands

President and Chief Executive Officer
Topa Insurance Company

Brenda Seuthe
Los Angeles, California

Chief Financial Officer
Topa Equities, Ltd.

* Retired effective December 31, 2006

John Anderson Jr. and Judith Munzig were elected directors on February 22, 2007

Principal Officers

Name

Title

Noshirwan Marfatia
William S. Anderson
Daniel Sherrin
Olha Tiberg
Harry E. Good
Larry Esposito

President and Chief Executive Officer
Vice President and Secretary
Vice President, Chief Financial Officer and Treasurer
Vice President
Vice President
Vice President

Management Agreement

Investment Management Agreement: On September 6, 1993, the Company entered into an investment management agreement with Kayne, Anderson Investment Management, Inc. (KAIM). Under this agreement, the Company retains KAIM as its adviser to supervise and manage its invested assets. The agreement specifies a monthly management fee for these services of \$20,000.

Mr. John E. Anderson, the Company's ultimate controlling person and also a director of KAIM, previously held a 25% ownership interest of KAIM.

On December 1, 2000 KAIM changed its legal name to Kayne Anderson Rudnick Investment Management, LLC (KARIM). On October 1, 2001 the California Department of Insurance (CDI) gave approval to amend and restate the investment management agreement between the Company and KARIM. The amended agreement also increased the management fee from \$20,000 to \$27,500 per month.

On November 1, 2001, KARIM sold 60% of its interest to Phoenix Investment Partners, Ltd. reducing John E. Anderson's interest in KARIM to 9.6% and in 2005 the remaining 9.6% was sold to Phoenix Investment Partners, Ltd.

Intercompany Agreements

Office Lease Agreement: On August 22, 1995, the Company, as tenant, entered into an Office Lease Agreement with its parent, Topa Equities, Ltd, (TEL). Under this agreement, the Company pays an annual base rent plus 7.93% of the direct building operating expenses of TEL. The agreement was renewed effective October 1, 2005 expiring on January 31, 2009. The lease extension was approved by the CDI on September 30, 2005. In November 2003, the Company entered into a new lease agreement with Topa Management Company (TMC), a wholly-owned subsidiary of TEL, for additional rental space. The lease, effective November 15, 2003 and expiring January 31, 2009 was approved by the CDI on November 18, 2003. The Company paid TEL rental fees of \$965,630, \$999,970 and \$1,042,569 in 2004, 2005, and 2006, respectively.

Tax-Savings Agreement: Under the terms of the Tax-Savings Agreement dated January 1, 1998, the Company and its ultimate parent, TEL, file a consolidated federal income tax return. The Company's tax liability, under the terms of this agreement, is no more than what it would have been had it filed on a separate stand-alone basis. During the period under examination the Company paid TEL \$1,142,775, \$1,550,000 and \$2,350,000 for the years 2004, 2005 and 2006, respectively. The

total payments represent approximately 22% of net income before taxes for the combined period under examination.

Although it did not require prior approval, the Company submitted the Tax-Savings Agreement to the CDI for review as requested during this examination.

Brokerage Agreement: The Company entered into a brokerage agreement with its affiliate, Topa Insurance Services, Inc. (TISI), on February 5, 1996. Under this agreement, TISI, as a broker, is not authorized to bind insurance unless prior submission is made and written approval is obtained from the Company. TISI receives a commission based on a negotiated rate on a per policy basis. The Company paid TISI commissions of \$122,940, \$97,637 and \$95,100 for the years 2004, 2005 and 2006, respectively.

Agency Agreement: The Company entered into an agency agreement with its affiliate, McNabb Insurance Services, Inc. (McNabb), on February 1, 2002 which was approved by the CDI on December 20, 2002. Under this agreement, McNabb is authorized to bind personal and commercial lines of business written in California (with specified limits). The Company paid McNabb commissions of \$3,432,000, \$3,916,000 and \$3,668,000 for the years 2004, 2005 and 2006, respectively, which approximates a 23% commission rate for the period under exam. The non-affiliated commission rates range from 15% to 30% depending on the line of business.

Agency Agreement: The Company entered into an agency agreement with its affiliate, Nevada Pacific Insurance Services, Inc. (Nevada Pacific) on February 1, 2002, which was approved by the CDI on December 20, 2002. Under this agreement, Nevada Pacific is authorized to bind personal and commercial lines of business written in Nevada (with specified limits). The Company paid Nevada Pacific commissions of \$3,130,000, \$2,670,000 and \$2,396,000 for the years 2004, 2005 and 2006, respectively, which approximates a 23% commission rate for the period under exam. The non-affiliated commission rates range from 15% to 30% depending on the line of business.

Contingent Commission (Profit Sharing) Agreements: Effective January 1, 2003, the Company entered into contingent commission agreements with McNabb and Nevada Pacific. Both agreements

were approved by the CDI on December 31, 2003. The Company paid McNabb contingent commissions of \$220,350, \$601,288 and \$722,000 for the years 2004, 2005 and 2006, respectively. There were no contingent commissions paid to Nevada Pacific during the period under examination.

CORPORATE RECORDS

California Insurance Code (CIC) Section 735 states that the Company must inform the board members of the receipt of the examination report. The board should be informed of the report both in the form first formally prepared by the examiners and in the form as finally settled and officially filed by the Commissioner. The board must also enter that fact in the board minutes. A review of the board minutes disclosed that there was no entry indicating either the draft or the final report was presented to the board. It is recommended that the Company implement procedures to ensure future compliance with CIC Section 735. The Company acknowledged that the submission of the examination draft and final report was not properly documented in the board minutes but that the board did review the draft and final report. The Company will ensure that the draft and final report presentation to the board is properly documented in compliance with CIC Section 735.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2006, the Company is licensed to transact insurance in Arizona, California, Colorado, District of Columbia, Georgia, Nevada, Oklahoma, Utah and Virginia. It operates on a surplus lines basis in the U.S. Virgin Islands and in the following states: Alabama, Florida, Hawaii, Illinois, Ohio, Oregon, Texas, Utah, Washington, West Virginia and Wisconsin.

As of December 31, 2006, the Company's direct written premiums were \$126.1 million. The following reflects the largest premium producing states and territories:

<u>State/Territory</u>	<u>Volume</u>	<u>% of Total</u>
California	\$106,657,106	84.6%

<u>State/Territory</u>	<u>Volume</u>	<u>% of Total</u>
Nevada	10,151,095	8.0%
Arizona	3,994,623	3.2%
Oklahoma	2,711,486	2.1%
U.S. Virgin Islands	776,735	0.6%
District of Columbia	765,064	0.6%

The Company's overall premium production is approximately 65% commercial lines and 35% personal lines. The Company's commercial coverages emphasize commercial automobile, commercial multi-peril, general liability, and workers' compensation. Workers' compensation coverage is written only for the Company's ultimate parent Topa Equities, Ltd. Personal lines operations consist of private passenger automobile and a small book of homeowner's business. Personal lines business is distributed through independent agents. Specialty commercial lines products are distributed through wholesale brokers.

REINSURANCE

Assumed

The Company assumes a minimal amount of commercial property reinsurance covering risks originating in the U.S. Virgin Islands from its wholly-owned subsidiary, Dorchester Insurance Company, Ltd. As of December 31, 2006, the Company's reinsurance payable on case reserves amounted to \$34,000.

The following is the summary of the Company's assumed reinsurance:

Type of Contract	Reinsured Name	Reinsured's Retention	Company's Maximum Limits
Property (Catastrophe)	Dorchester Insurance	\$250,000 per occurrence	\$250,000 excess of

Type of Contract	Reinsured Name	Reinsured's Retention	Company's Maximum Limits
Excess of Loss Treaty	Company, Ltd.		\$250,000– one occurrence \$750,000 – aggregate
Property (Catastrophe) Excess of Loss Treaty	Dorchester Insurance Company, Ltd.	\$6 million per occurrence	\$1 million excess of \$6 million- per occurrence and aggregate
Property (Non-Catastrophe) Excess of Loss Treaty	Dorchester Insurance Company, Ltd.	\$100,000 per occurrence	\$100,000 excess of \$100,000– one occurrence \$750,000 – aggregate

Ceded

The following is a summary of the Company's ceded reinsurance in force as of December 31, 2006:

Type of Contract	Reinsurer's Name and Participation Percentage	Company's Retention	Reinsurer's Maximum Limits
Property Damage Quota Share excluding Windstorm	55.00% Everest Reins Co. 29.00% Allianz Suisse 16.00% Amlin Bermuda, Ltd.	10% of \$2 million per risk	90% of \$2 million per risk \$65 million maximum aggregate for earthquakes
Property Damage Quota Share excluding Windstorm & Earthquake	80.00% Lloyd's Underwriters	20% of \$1 million per risk	80% of \$1 million per risk \$10 million one event
Non-Standard Private Passenger Auto Liability Quota Share (Multi-State policies only)	25.00% Odyssey America Reins. 15.00% ACE P&C Ins. Co. 10.00% QBE Reins. Corp.	a) 50% of net retained liability b) 50% of \$40,000 per risk	a) 50% of maximum limits per policy b) 50% of \$40,000 per risk
Real Estate Agents Errors & Omissions Quota Share	35.00% Folksamerica Reins. 15.00% GE Reins. Corp. 10.00% ACE P&C Ins. Co. 10.00% Hannover Ruck 5.00% Everest Reins. Co.	25% of \$1 million	75% of \$1 million
1 st Property Excess of Loss	32.50% GE Re (Swiss Re). 25.00% Endurance Specialty 15.00% QBE Reins Corp. 15.00% Toa Re 7.50% Hannover Ruck 5.00% Odyssey Re.	a) \$250,000 per risk, per occurrence, (Section A) b) \$200,000 per risk, per occurrence, (Section B)	a) \$1.25 million b) \$1.3 million
Commercial Auto & Truck Liability Excess of Loss	25.00% Odyssey America Reins. 25.00% QBE Reins. Corp. 15.00% ACE P&C Ins. Co. 15.00% Berkley Ins. Co. 15.00% Motors Ins. Co. 5.00% Hannover Ruck	\$200,000 per occurrence, per policy	\$800,000 per occurrence, per policy
1 st Casualty	35.00% Folksamerica Reins.	Casualty Contingency:	\$2 million excess of

Type of Contract	Reinsurer's Name and Participation Percentage	Company's Retention	Reinsurer's Maximum Limits
Contingency / Clash Excess of Loss	25.00% Hannover Ruck 15.00% QBE Reins. Corp. 15.00% Toa Reins. Company	a) \$250,000 per occurrence, per policy (except CRES program) b) \$350,000 per occurrence, per policy (CRES program). Clash Coverage: c) \$350,000 per occurrence, involving two or more policies (except CRES program). \$450,000 per occurrence, involving two or more policies (CRES program)	Company's retention in a, b, c & d.
1 st Casualty Excess of Loss	45.00% Hannover Ruck 15.00% QBE Reins. Corp. 15.00% Toa Reins Company	\$250,000 per occurrence, per policy	\$750,000 per occurrence, per policy
2 nd Casualty Excess of Loss	25.00% GE Reins. Corp. 20.00% Endurance Specialty 20.00% Hannover Ruck 15.00% QBE Reins. Corp. 15.00% Toa Reins Company	\$1 million per occurrence, per policy	\$4 million per occurrence, per policy
1 st Layer Catastrophe Excess of Loss	25.00% Lloyd's Underwriters 10.00% Hiscox Insurance Co. 7.50% American Re-Ins. Co. 7.50% QBE Reins. Corp. 5.00% Montpelier Reins., Ltd. 5.00% Munchener Ruck	\$1 million	\$4 million per occurrence \$8 million aggregate
2 nd Layer Catastrophe Excess of Loss	20.00% American Re-Ins. Co. 12.50% Hiscox Insurance Co. 12.50% Mapfre Re Compania 10.00% Endurance Specialty 10.00% Hannover Ruck 10.00% Munchener Ruck 7.50% GE Reins. Corp. 7.50% QBE Reins. Corp. 5.00% Montpelier Reins., Ltd.	\$5 million	\$10 million per occurrence \$20 million aggregate
3 rd Layer Catastrophe Excess of Loss	20.00% Hiscox Insurance Co. 20.00% Munchener Ruck 15.00% Mapfre Re Compania 10.00% Endurance Specialty 10.00% Hannover Ruck 10.00% Montpelier Reins., Ltd. 7.50% GE Reins. Corp. 7.50% QBE Reins. Corp.	\$15 million	\$10 million per occurrence \$20 million aggregate

The Company also purchases facultative reinsurance for amounts in excess of the Company's retention and limits.

As of December 31, 2006, reinsurance recoverables, for all ceded reinsurance totaled \$57.2 million or 74.9% of surplus as regards policyholders. \$57.0 million of the reinsurance recoverables were from non-affiliated admitted reinsurers.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

Reconciliation of Examination Changes as of December 31, 2006

Statement of Financial Condition
as of December 31, 2006

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 125,838,928	\$	\$ 125,838,928	
Stocks:				
Preferred stocks	4,529,771		4,529,771	
Common stocks	48,680,318		48,680,318	
Cash and short-term investments	3,528,099		3,528,099	
Receivable for securities	5,000		5,000	
Investment income due and accrued	2,074,320		2,074,320	
Uncollected premiums and agents' balances in course of	9,796,465	249,847	9,546,618	
Deferred premiums, and agents balances and installments booked				
but deferred and not yet due	6,927,721	393,703	6,534,018	
Amounts recoverable from reinsurers	2,104,549		2,104,549	
Net deferred tax asset	3,770,057		3,770,057	
Electronic data processing equipment and software	2,408,074	2,235,156	172,918	(1)
Furniture and equipment	246,671	246,671	0	
Aggregate write-in for other than invested assets	<u>118,755</u>	<u></u>	<u>118,755</u>	
Total assets	<u>\$ 210,028,728</u>	<u>\$ 3,125,377</u>	<u>\$ 206,903,351</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 79,739,521	(2)
Loss adjustment expenses			5,055,043	(2)
Commissions payable, contingent commissions and other similar charges			1,474,531	
Other expenses			2,208,479	
Taxes, licenses and fees			152,109	
Current federal and foreign income taxes			547,383	
Unearned premiums			35,216,245	
Ceded reinsurance premiums payable			7,961,345	
Amounts withheld or retained by company for account of others			123,434	
Payable for securities			308,885	
Aggregate write-ins for liabilities			<u>13</u>	
Total liabilities			132,786,988	
Common capital stock		\$ 5,000,000		
Gross paid-in and contributed surplus		23,639,733		
Unassigned funds (surplus)		<u>45,476,630</u>		
Surplus as regards policyholders			<u>74,116,363</u>	
Total liabilities, surplus and other funds			<u>\$ 206,903,351</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income

Premiums earned		\$ 86,726,967
Deductions:		
Losses incurred	\$ 45,798,637	
Loss expenses incurred	10,221,327	
Other underwriting expenses incurred	<u>31,283,922</u>	
Total underwriting deductions		<u>87,303,886</u>
Net underwriting loss		(576,919)

Investment Income

Net investment income earned	\$ 7,035,270	
Net realized capital gains	<u>2,087,833</u>	
Net investment gain		9,123,103

Other Income

Net loss from agents' balances charged off	<u>\$ (8,272)</u>	
Total other income		<u>(8,272)</u>
Net income before federal income taxes		8,537,912
Federal income taxes incurred		<u>1,632,000</u>
Net income		<u>\$ 6,905,912</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		\$ 64,750,262
Net income	\$ 6,905,912	
Net unrealized capital gains	3,374,719	
Change in net deferred income tax	1,790,316	
Change in nonadmitted assets	(1,524,846)	
Capital adjustments: Paid-in	2,400,000	
Surplus adjustments : Paid-in	(2,400,000)	
Dividends to stockholders	<u>(1,180,000)</u>	
Change in surplus as regards policyholders for the year		<u>9,366,101</u>
Surplus as regards policyholders, December 31, 2006		<u>\$ 74,116,363</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

Surplus as regards policyholders, December 31, 2003, per Examination			\$ 51,579,622
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 19,421,693	\$	
Net unrealized capital gain	4,752,875		
Change in net deferred income tax	3,010,511		
Change in nonadmitted assets		1,168,338	
Capital adjustments : Paid-in	2,400,000		
Surplus adjustments: Paid-in		2,400,000	
Dividends to stockholders	<u> </u>	<u>3,480,000</u>	
Totals	<u>\$ 29,585,079</u>	<u>\$ 7,048,338</u>	
Net increase in surplus as regards policyholders			<u>22,536,741</u>
Surplus as regards policyholders, December 31, 2006, per Examination			<u>\$ 74,116,363</u>

Reconciliation of Examination Changes
as of December 31, 2006

	<u>Per</u> <u>Company</u>	<u>Per</u> <u>Examination</u>	<u>Surplus</u> <u>Increase</u> <u>(Decrease)</u>	<u>Notes</u>
<u>Assets</u>				
Electronic data processing equipment and software	\$ 2,408,074	\$ 172,918	<u>\$ (2,235,156)</u>	(1)
Net decrease to surplus as regards policyholders			\$ (2,235,156)	
Surplus as regards policyholders, December 31, 2006 per Company			<u>76,351,519</u>	
Surplus as regards policyholders, December 31, 2006 per Examination			<u>\$74,116,363</u>	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Electronic Data Processing Equipment and Software

The captioned account was overstated by \$2,235,156 due to the inclusion of application software, which should have been nonadmitted pursuant to Statements of Statutory Accounting Principles No. 16, Section 2.

(2) Losses and Loss Adjustment Expenses

Based upon a review conducted by a Casualty Actuary from the California Department of Insurance (CDI), the Company's reserves for losses and loss adjustment expenses as of December 31, 2006 were found to be reasonably stated and have been accepted for the purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Company History (Page 2): It is recommended that the Company submit future notices of changes to its common stock and gross paid-in and contributed surplus to the California Department of Insurance (CDI) in a timely manner as required by California Insurance Code (CIC) Section 827.3(b)(3).

Corporate Records (Page 7): It is recommended that the Company implement procedures in its board meetings to ensure compliance with CIC Section 735. Company acknowledged that the submission of the examination draft and final report was not properly documented in the board minutes but that the board did review the draft and final report. The Company will ensure that the draft and final report presentation to the board is properly documented in compliance with CIC Section 735.

Electronic Data Processing Equipment and Software (Page 17): It is recommended that the Company not admit non-operating system software in accordance with Statements of Statutory Accounting Principles No. 16 Section 2.

Previous Report of Examination

Accounts and Records (Page 8): It was recommended that the Company include an audit trail of all transactions in the Point System. In addition, it was also recommended that the Company regularly test its disaster recovery plan. The Point System still only supports an audit trail on a batch basis; however, approximately 75% of the premium transactions are generated and transmitted electronically to the Company through a batch interface from agents. The Company is currently in the process of implementing a new Business Continuity Plan and the electronic recovery of data was tested on three separate occasions during 2007.

Other Invested Assets (Page 14): It was recommended that the Company file for an exemption with the CDI under CID Section 1101 or divest itself of the joint venture investment with Kayne Anderson Capital Income Partners, L.P. The Company sold the investment in 2005.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/
Constance J. Korte, CFE
Examiner-In-Charge
Department of Insurance
State of California